

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Karnette Analyst: Marion Mann DeJong Bill Number: SB 1015

Related Bills: SB 304 1999/2000 Telephone: 845-6979 Introduced Date: 02/26/1999

Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Combined Reporting/Top Tier Corporations of Commonly Controlled Groups

SUMMARY

This bill would allow "top tier" corporate taxpayers to elect to include all the income and apportionment factors of the members of a commonly controlled group in a combined report, regardless of whether the group members are unitary.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

SB 1150 (1993/1994); SB 674 (1993/1994); SB 1805 (Stats. 1994, Ch. 1243); SB 711 (1995/1996); SB 1580 (1995/1996); AB 2499 (1995/1996); AB 417 (1997/1998); AB 601 (1997/1998).

SPECIFIC FINDINGS

The California Bank and Corporation Tax Law (B&CTL) requires unitary corporations with activities both within and outside California to combine all activities when determining business income apportionable to the state for tax purposes. Under the worldwide unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of the income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales. The California income is then apportioned to the members which are taxable in California, who each retain a separate tax identity and liability.

The B&CTL allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

The basic tests used to determine if corporations are "unitary" in nature are:

1. The three unities test: whether the corporations exhibit unity of ownership or control, unity of operation (as evidenced by central purchasing, advertising, accounting and management divisions), and unity of use in its centralized executive force and general system of operation (Butler Brothers v. McColgan (1941) 17 Ca.App.2d 664); and

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ <u>X</u> PENDING

Department Director

Date

Gerald Goldberg

4/13/1999

2. The contribution or dependency test (Edison California Stores v. McColgan (1947) 30 Cal 2nd 472).

The B&CTL contains bright-line tests to determine unity of ownership. A group of corporations is considered commonly controlled under the following conditions:

- if the corporations are connected by more than 50% stock ownership to a common parent corporation;
- if the same individual or entity holds stock possessing more than 50% of the voting power of the corporations;
- if the corporations are legally tied or bound together ("stapled") entities, as defined; or
- if the corporations are held by members of the same family, as defined.

Satisfying the other tests used to determine whether a corporation is unitary requires a case-by-case analysis of the taxpayers' situation. Factors used to establish whether a unitary business is present between two or more corporations include: intercompany sales; centralized management, purchasing and advertising; financing (lending capital between companies); the transfer of information; common pension, employee benefit, and insurance plans; and the sharing of facilities, trade name, trade marks, patents and processes. The importance of each factor may vary depending on the particular case.

Current Franchise Tax Board (FTB) legal rulings provide guidance for determining unitary status of holding companies.

The B&CTL also allows the FTB to permit or require the filing of a combined report or such other information needed to properly reflect income attributable to California by two or more taxpayers controlled directly or indirectly by the same interests, unless a valid water's-edge election is in effect.

The B&CTL provides for the use of an apportionment formula when assigning business income of multistate and multinational corporations to California for tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales. Each factor is the ratio of in-state activity to worldwide activity. The combined report is used to determine the apportionment percentage and the amount of income attributable to California.

This bill would allow a corporate enterprise to elect to determine the income and apportionment factors of all members of a commonly controlled group in a single combined report. This election would be allowed even if the income and apportionment factors were not all part of a unitary trade or business. Only the top tier corporation could make the election to file a single combined report. If more than one corporation fits the definition of top tier, all top tier members must elect.

This bill would define a top tier corporation as a member of a commonly controlled group that is (1) a parent corporation, (2) a brother-sister parent corporation, or (3) a any other member of the commonly controlled group which is not owned more than 50% by a parent corporation. A top tier corporation would not have to be a California taxpayer.

This bill also would define "brother-sister parent corporation," "parent corporation," and "corporation."

This bill would provide rules regarding the form and length of the election. The election would remain in effect for ten years and would commence on the first day of the income year designated in the election. If the taxpayer requests and has good cause, the FTB would be able to terminate the election early. The FTB would prescribe the form and manner for the election, which must be made by all the top tier members before the first day of the designated income year. The election is automatically renewed for another 10 years unless one of the top tier members files a notice of nonrenewal before the end of the 10 year period.

This bill would provide that if an election is terminated or not renewed, another election may not be made for any income year beginning five years after the last day of the election period that was terminated or not renewed. FTB may waive this rule for good cause.

This bill grants the FTB the discretion to treat a defective election as void or allow its perfection. This bill does not specify any factors that the FTB should take into account when making its determination of whether to void or perfect the election. The statute of limitations would remain open for adjustments resulting from the perfection or voiding of the election for all taxpayers in the group whose income year falls within the 10-year elective period.

This bill would allow all income to be apportioned by a single apportionment formula, modified, if appropriate, by specified regulations. Certain conditions would be imposed for using the special apportionment formulas. Neither the department nor the group members may rely upon the existing law, which authorizes special apportionment formulas, to (1) prevent the income and apportionment factors of any group member from being included in the single combined report or (2) assert that the election has had the effect of unfairly reflecting the extent of any group member's activity in California or any other state.

With the exception of certain stock transactions between group members, which would be deemed business income, business and nonbusiness income would be determined and treated under existing laws. Regulations also shall prescribe the appropriate accounting adjustments which may be needed to account for a termination or nonrenewal of an election. The income and apportionment factors of a member may not be included in the combined report if other provisions of California law would normally prohibit their inclusion, such as the law which generally prevents Subchapter S corporations from being included in a combined report.

This bill would require the top tier corporations to waive expressly, on behalf of all members, any constitutional objections to the fact or effects of the election.

This bill would specify how the departure of a group member would affect the election. If a corporation other than a top tier member leaves the group, the election would remain valid for the remaining members. If the corporation transfers to another group, that corporation would generally take the elective or non-elective status of the acquiring parent.

If a top tier member leaves the group, the rules would vary depending on whether the new group has elected, if there are other top tier members in the new group, and the remaining length of the election periods for each top tier member.

This bill would provide rules to address certain situations involving corporate organizations, reorganizations, and mergers. Generally, for organizations and reorganizations, **this bill** would have the election remain in effect and any new top tier corporations would constitute electing top tier corporations if the members were subject to the election before the organization or reorganization or were formed to acquire stock or assets which belonged to an electing member. For mergers of top tier corporations, this bill would treat the election of a top tier corporation as a tax attribute under the Internal Revenue Code (IRC), and the electing or nonelecting status of the surviving corporation would be determined by FTB regulations. Designating the election as a tax attribute would mean that the election would be treated as one of a number of items (methods of accounting, depreciation, inventories, etc.) which may vary between two merging corporations and require resolution on which corporation's method should be used by the surviving corporation.

This bill also would provide rules regarding the income and apportionment factors of two or more members which are on different income years and either become subject to an election or are members of an electing group which terminates the election. **This bill** would provide rules for taking into account income and factors of new members. Rules are provided to cover when a taxpayer has the same income year as the rest of the group and joins the group in mid-year. These rules also cover situations where the members have or have not filed a combined report in prior years.

This bill would provide special rules for a combined reporting election made in conjunction with a water's-edge election. Through the interaction of this bill and the existing water's-edge statutes, any group which elected both water's-edge and combined reporting would contain all entities required to be included in the water's-edge group and any additional corporations which may be added by the election made under this bill. If any member is already part of a water's-edge group when the reporting election is made, then all taxpayer members shall be treated as part of the water's-edge group and subject to the water's-edge laws. If the reporting election is made first, all members of the group must make the water's-edge election as a single water's-edge group.

This bill would allow a single corporation to elect to file as if all its income were from a single trade or business. **This bill** would provide rules under which another member becomes part of the single corporation's election.

This bill would allow the FTB to prescribe any necessary regulations to carry out the purposes of this bill.

This bill also would specify that group members shall be treated as if they were engaged in a unitary business.

This bill would require taxpayer members of a commonly controlled group that elect to file a single combined report to attach to their tax return a schedule listing all corporations in the commonly controlled group, regardless of whether the income and apportionment factors are properly included in the combined report.

This bill would provide that if the taxpayer members fail to attach the schedule, or attach an incomplete schedule, a penalty for \$1,000 for each corporation not

disclosed may be assessed against the taxpayer members of the commonly controlled group. If any taxpayer member fails to provide the schedule upon notice from the FTB, or demonstrates substantial noncompliance for two or more income years, the penalty is increased to \$5,000 for each corporation not disclosed. The penalty would be waived in whole or in part for reasonable cause and could be assessed against any member of the group. Each taxpayer member shall be jointly and severally liable for the penalty.

Policy Considerations

This bill would raise the following policy considerations:

- This bill would allow nonunitary groups to file a combined report based only upon common control, which would be similar to the federal consolidated return. It can be expected that the top tier members would make this election when it could be used to obtain the best tax advantage. The tax advantage effect of the election is somewhat mitigated by the fact that the election is binding for 10 years and perhaps by taxpayers' electing because of reduced compliance costs.
- A few other states accept "consolidated" returns that allow the taxpayers to consider only common ownership when filing. However, no other state has authorized an elective combined filing similar to the election proposed by this bill. This bill establishes unique filing/compliance criteria.
- This bill would not define "unitary" for non-electors. The department would continue to conduct audits regarding the unitary issue and combine or de-combine groups. Thus, disputes between non-electing taxpayers and the department will continue to arise.

Implementation Considerations

This bill specifies that the designated income year shall not begin before January 1, 1997. As drafted, the bill would allow taxpayers to make an election for income years beginning on or after the enactment date of the bill; however, the election must be made before the first day of the designated income year. Taxpayers with income years beginning before the enactment date of this bill would not be able to make the election until the next income year, while taxpayers with income years beginning after the date of enactment could make the election for the 1999 income year. In addition, the department would need time to provide instructions for making elections to taxpayers. To provide consistency for taxpayers and for ease of administration, the bill should become operative for income years beginning on or after January 1, 2000. As requested by the author's staff, Amendment 1 would make this change.

Technical Considerations

Amendment 2 would allow FTB (at its discretion) to permit defective elections to be perfected rather than allowing FTB (at its discretion) to treat a defective election as perfected or void. Defective elections are by their nature void; thus, the department does not need discretionary authority to treat a defective election as void.

Department staff is working with the author to resolve other technical considerations regarding (1) the 60-month restriction from making an election when the election is terminated or not renewed, (2) the penalty relating to attaching the schedule of member corporations, and (3) a definition for taxpayer member.

REGULATIONS

This bill would specify that the FTB may promulgate any necessary regulations to carry out its purposes.

FISCAL IMPACT

Departmental Costs

To the extent that this provision prevents disputes between the taxpayers and the department over whether a group is unitary, cost savings for the department's audit and legal staff may result. The extent of these possible savings cannot be quantified.

Tax Revenue Estimate

Based on limited data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of SB 1015 As Introduced 02/26/99 [\$ In Millions]				
Fiscal Year Impact				
1999-00	2000-01	2001-02	2002-03	2003-04
(\$2)	(\$2)	(\$3)	(\$25)	(\$41)

The bill would be effective with income years beginning on or after January 1, 1999, with enactment assumed after June 30. Fiscal-year cash flow impacts beginning in 2002-03 reflect the three to four year audit cycle that would normally apply in cases where the department would reverse self-assessed taxpayer reporting under current combination standards.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Tax Revenue Discussion

The number of corporations that elect to combine with commonly controlled corporations and the resultant reduction in tax liabilities would determine

the revenue impact of this bill. This bill is identical to AB 417 as amended April 22, 1997.

Audit data was primarily used to estimate revenue losses attributed to taxpayers likely to elect to combine with nonunitary commonly controlled members. An allowance was made for the impact of dividends (currently included at least partially in the measure of tax) that would be eliminated as intercompany dividends under elective combination.

An additional revenue effect that is not measured due to nonexistent data is the potential impact of future merger/acquisition activity.

BOARD POSITION

Pending.

Marion Mann DeJong
(916) 845-6979
Doug Bramhall

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1015
As Introduced February 26, 1999

AMENDMENT 1

On page 5, line 2, strikeout "1997" and insert:

2000

AMENDMENT 2

On page 5, modify lines 30 through 39 as follows:

(7) The Franchise Tax Board may, in its discretion, ~~treat~~ permit defective elections under this section ~~as void or permit the election~~ to be perfected during the period of limitations prescribed under Section 19057 and 19306 for the applicable income year. The statute of limitations of all taxpayers in the commonly controlled group whose income year falls, in part or in whole, within the 120-month period of the election shall remain open to receive adjustments, under claim or deficiency, consistent with a ~~voiding or~~ perfection of the election.